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MANUFACTURERS HANOVER

Financial Digest

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Analysis of Business Trends Plus Selected Financial Indicators

The Stock Market Takes a Tumble

With the Dow Jones Industrial Average posting its steepest one-day plunge ever last Monday, virtually everyone is asking why this happened and what are its implications for the future. To be sure, although the answer to the latter question is the subject of considerable speculation, the volatility that gripped the stock, bond and currency markets is a bit less difficult to explain. It is a reflection of several well-founded domestic and international concerns as well as, for the stock market at least, the growing dominance of large institutional investors employing innovative, computer-assisted trading techniques. Whether designed to enhance the profits of program traders or to afford a degree of portfolio insurance, these techniques, involving the use of stock index futures and options, are widely believed to have magnified stock price swings in both directions.

Among the more fundamental concerns have been a reawakening of inflation expectations, the recent rise in interest rates and the downside vulnerability of the dollar in the foreign exchange markets, all of which are largely the unwelcome by-products of this country's inability to deal effectively with the Federal budget and foreign trade deficits. Since it is highly unlikely that these fears will disappear anytime soon, periodic bouts of financial turmoil may well become a permanent feature of the economic landscape.

Perhaps the biggest problem unsettling the financial markets is the decided rebound in inflation expectations, and the shift in long-term interest rates which has accompanied this change in investor psychology. Although it may seem that analysts are endlessly debating to what extent inflation is, or is not, back, such developments as rising industrial commodity prices, increasing capacity utilization rates and a pickup in wage rates all point to a fundamental deterioration in the inflation rate outlook. Paced by rising steel and copper prices, industrial commodity prices continue to rise at double-digit annual rates; what is more, producer price inflation, excluding the volatile food and energy components, has been accelerating for over a year.

Higher Inflation Expectations

The harbingers of higher rates of inflation are not confined to industrial commodity prices. They also include rising capacity utilization rates in several basic industries and a tightening of labor market conditions, which is now putting upward pressures on wages. Take, for example, operating rates. Although the nationwide rate of capacity utilization remains at a relatively modest 81 percent, such industries as paper and textiles are operating at, or close to, full capacity, while such others as the rubber and plastics industries are generally approaching the 90-percent neighborhood.

So, too, as the labor market moves toward full employment, wages which account for some two-thirds of all manufacturing costs are on the rebound. Average hourly earnings, whose growth was virtually flat earlier this year, have been advancing at a better than four percent annual rate over the past three months throughout the private sector and, in the manufacturing sector in particular, at a better than five percent annual clip. While these numbers may seem modest, they mark a decided shift in the pace of wage increases and are widely viewed as a forerunner of even more rapid rises in labor costs next year.

Dollar Concerns Mount

While deteriorating inflation psychology is one major factor behind the current turmoil, another big negative is the persistence of a huge merchandise trade deficit and all of its unwanted by-products. The most prominent of these are a weak dollar in the foreign exchange markets, rising protectionist sentiment within Congress and, from time to time, public policy disagreements with some of our largest trading partners. Indeed, some analysts attribute last Monday's stock price debacle in part to trans-Atlantic feuding over the appropriate stance of German monetary policy, which was being tightened, and the resulting fear among many financial market participants that a breakdown in international cooperation could quickly spell a

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weaker dollar and higher domestic interest rates.

This is because the United States has evolved into a net debtor country in recent years, dependent upon foreign capital inflows to help balance our books and keep the lid on upward interest rate pressures. In this environment, any factor which diminishes the relative attractiveness of U.S. dollar-denominated assets, whether a rise in interest rates overseas or a dip in returns available here, could quickly have negative repercussions, weakening the dollar and heightening inflation rate expectations.

Rising inflation expectations and the persistence of a huge trade imbalance seem to have provided the one-two punch necessary to flatten the financial markets. Which brings us to the second question: Namely, what does all this mean for the future? Ironically, if the past is any guide and the plunge in share prices does hasten the onset of another recession some six to 12 months from now—by eroding business and investor confidence, not to mention curbing the spending enthusiasm of the general public—it could provide something of a remedy to the ills which caused the collapse in share prices in the first place.

Short Term Paper Outstanding

(Millions of Dollars)

Time Deposits of $100,000 or more Weekly Reporting Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (10/7/87)	169,068	+ 4,063	+ 13,830
New York City (10/14/87)	38,628	– 324	+ 5,021
Commercial Paper (10/14/87)	361,745	+ 1,472	+ 31,065

Bank Loans

(Millions of Dollars)

Commercial and Industrial Loans

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (10/7/87)	274,554	– 611	+13,314
New York City (10/14/87)	59,446	+ 469	+ 645

Total Loans and Leases Gross Adjusted

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (10/7/87)	801,948	– 5,367	+50,684
New York City (10/14/87)	178,445	+ 2,488	+16,067

Financial Markets

	Friday 10/23/87	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	5.34%	– 1.80	– .04
180-Day Bills†	6.16	– 1.81	+ .63
Longest Bills†	6.91	– 1.41	+ 1.16
Recent Issues:			
77/8S 10/31/87 (When Issued)	7.74	NA	
91/8S 9/30/91	8.45	– 1.25	
85/8S 8/15/97	8.98	– 1.24	
87/8S 8/15/17	9.10	– 1.13	
Municipals:			
Bond Buyer–20 Bond Index* (10/22/87)	8.72%	– .45	+ 1.61
Blue List Total ($ Million)	$1,057	– $380	– $511
30-Day Visible Supply ($ Million)	$1,810	+ $ 87	– $284
Total	$2,867	– $293	– $795
Corporates:			
Moody's Aa Composite (10/22/87)	10.88%	– .14	+ 1.55
30-Day Visible Supply ($ Million)	$3,580	+ $935	–$1,662
Stocks:			
Dow-Jones Averages:			
Industrials	1,950.76	– 295.98	+ 118.50
Transportation	748.95	– 192.70	– 76.05
Utilities	183.82	– 6.32	– 18.45
65 Stocks	722.47	– 117.30	– 2.96
N.Y.S.E. Composite Index	139.18	– 19.95	+ 1.91
N.Y.S.E. Avg. Daily Vol. for Week (000's)	460,012	+ 235,262	+ 332,980

*34% Taxable equivalent 13.21%.

† Bond equivalent

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 10/23/87	Week Ago
Overnight	6.63%	7.50%
1 month	6.94	8.00
3 month	7.50	9.06
6 month	7.50	9.25
1 year	7.88	9.69
EURODOLLAR BONDS Average Yield		
Medium Term (5 yrs.)	8.65%	8.65%
Long Term (10 yrs.)	9.42	9.42

FOREIGN EXCHANGE SPOT RATES

New York Opening (10/23/87)	Currency Per U.S. $	Week Ago
Canada	1.3162	1.2995
France	6.0350	6.0125
Germany	1.8110	1.8000
Italy	1303.50	1300.00
Japan	144.25	142.45
Mexico	1638.00	1621.00
Switzerland	1.5050	1.4918
U.K.*	1.6540	1.6657

*U.S. $ per U.K. pound

MH TRADE-WEIGHTED DOLLAR (10/23/87) (Adjusted for Inflation)	Change Since Week Ago	Change Since 2/27/8
	+1.0%	–3.1%

A decided slowing of business activity would dampen inflation expectations, reverse the upward trend in interest rates and diminish the demand for foreign imports, narrowing the trade deficit and bolstering the dollar in the foreign exchange markets. In fact, some of the price rebound in the long-term bond market, as well as the recent uptick in the dollar, may be the result of the growing popularity of just such thinking.

No Replay of 1929

But before we get to that point, it should be kept in mind that not all of the recent news is negative, nor is this a replay of the 1929 experience. With funds flowing out of stocks and into the debt markets, bond prices have already rebounded considerably and interest yields have moved sharply lower, the dollar has moved higher in the face of a renewed commitment by the major industrial countries to exchange rate stability, and "bottom fishing" is providing at least a temporary floor to share prices. This news, together with the safeguards put in place subsequent to the events of 1929, will limit the damage done by the recent financial market turmoil. ■

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 10/21/87	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	223.919	+ 5.416	+25.985
Loans to Depository Inst.	1.111	+ .209	+ .223
Float	.906	+ .172	+ .278
Total Reserve Bank Credit	242.464	+ 5.897	+26.372
Treasury Deposits with Federal Reserve Banks	12.191	+ 8.910	+ 8.639
Currency in Circulation	219.090	+ .128	+16.345
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	188.315	– 1.061	+24.305
	10/21/87		
Member Bank Reserves:			
Total Reserves Held	58.072	+ .827	+ 5.464
Excess (Deficiency)	1.134	+ .286	+ .383
Net Free Reserves	.609	+ .487	+ .141
Monetary Aggregates †		**% Change Since 3 Months Ago***	**% Change Since Year Ago**
M1 (10/12/87)	753.7	+ 4.2‡	+ 8.3‡
M2 (September '87)	2,874.7	+ 4.7	+ 5.0
M3 (September '87)	3,622.6	+ 5.2	+ 5.8
Domestic Nonfinancial Debt (2nd Q'87)	7,954.0	+ 8.4	+ 11.0

†Seasonally adjusted.

*Seasonally adjusted annual rate.
‡Four-week moving average.

New York Money Market

Offering Rates 10/23/87	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	5.39%	5.92%	6.52%
* Federal Agencies	6.80	7.00	7.50
* Municipal Notes—High Grade (34% Taxable Equivalent)	7.73	7.95	8.33
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	7.55	7.65	8.00

‡Finance Company Paper—Prime

5- 14 days	6.55%
15- 29 days	6.70
30- 59 days	6.80
60- 89 days	6.95
90-179 days	7.13
180-239 days	7.13
240-270 days	7.13

‡* Bankers' Acceptances

Nov.	7.05%
Dec.	7.10
Jan.	7.28
Feb.	7.30
Mar.	7.30
Apr.	7.30

‡Industrial Paper—Prime

30- 89 days	6.88%
90-120 days	7.40

†Federal Funds Effective Rate 7.10%

‡Discount basis. *Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	3rd Q'87n	$ 4,512	$ 4,445	$ 4,266
Gross National Product (1982 Dollars)*	3rd Q'87n	$ 3,831	$ 3,795	$ 3,718
Percent Change, Annual Rate	3rd Q'87n	3.8	2.5	1.4
Change in Consumer Prices*	Sep '87n	2.4% (1)	6.0% (1)	3.6%
Change in Producer Prices*	Sep '87n	3.6%	0.0%	3.6%
Civilian Employment (Thousands of Persons) †	Sep '87	112,772	113,081	109,987
Unemployment as % of Civilian Labor Force †	Sep '87	5.9%	6.0%	7.0%
Personal Income*	Aug '87	$ 3,750	$ 3,732	$ 3,553
Leading Indicators Composite Index (1967=100)†	Aug '87	192.6	191.4	180.3
Industrial Production Index (1977=100) †	Sep '87n	131.2	131.0r	124.5r
Net Change in Consumer Installment Credit †	Aug '87	$ 4.66	$ 3.35	$ 5.61
U.S. Merchandise Trade Balance	Aug '87n	–$ 15.68	–$ 16.47	–$ 14.03
Plant and Equipment Expenditures*	4th Q'87	$406.37(a)	$398.04(a)	$388.69
Private Housing Starts (Thousands of Units)*	Sep '87n	1,669	1,598r	1,689
New Construction Expenditures*	Aug '87	$ 399.6	$ 393.4	$ 395.3
Total Business Inventories †	Aug '87n	$ 678.8	$ 677.7r	$ 655.6r
Total Business Sales †	Aug '87n	$ 458.7	$ 452.7r	$ 423.0r

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. r-Revised. a-Anticipated.
(1) Indicates new series.

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